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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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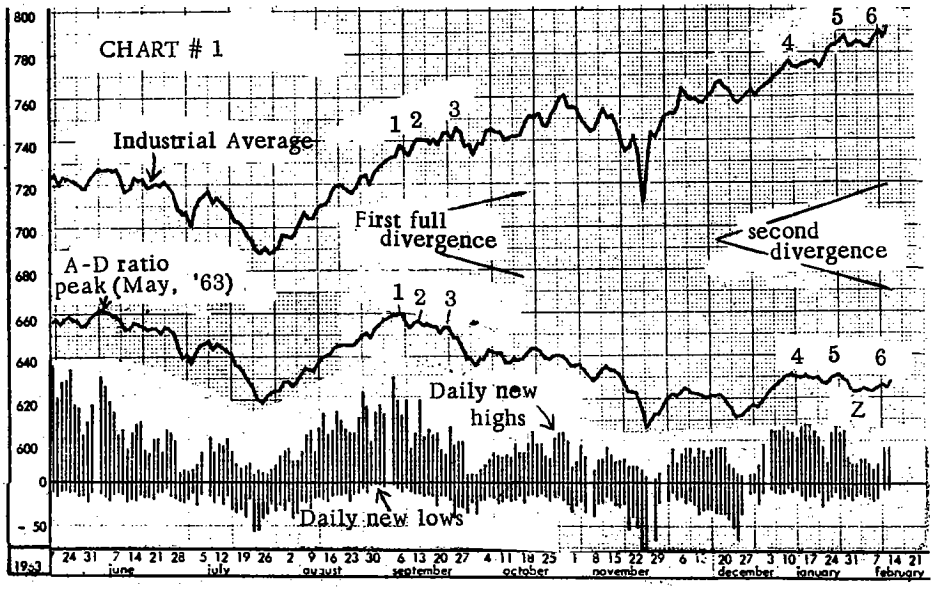
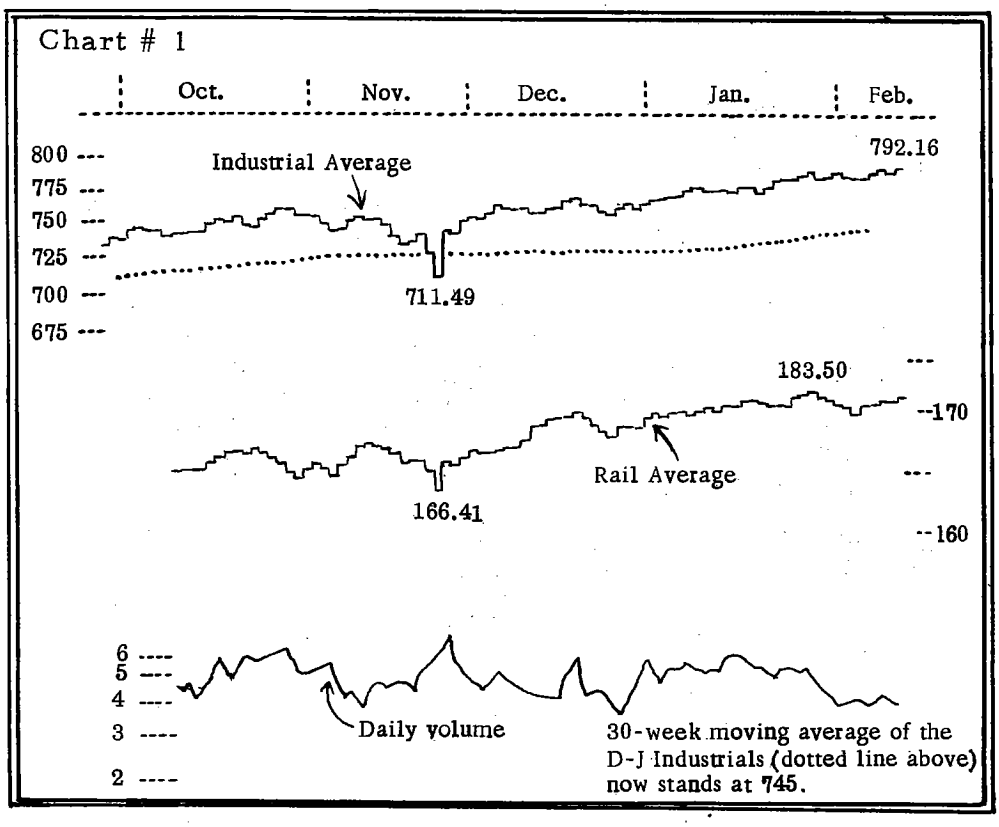
CONFUSION: I have followed the market for many years, and I have followed and corresponded with leading market analysts for many years, but I do not ever remember seeing as much utter confusion and divergence of opinion among market students as now. The Industrial and Rail Averages have been going up (Industrials are in an amazing "broadening pattern"); the majority of issues are sinking; odd-lotters have switched from heavy selling to approximately even buying and selling; Barron's Confidence Index gave a "sell signal" at 94, then popped up (this week) to a "revised" new high figure of 96.3; a leading bank credit analyst is bullish for the long-term but cautious for the intermediate term; another leading bank credit analyst is bearish on both counts. Joseph Granville has been headlining his advertisements in Barron's: "Are you making money in today's market?", and I am sure he is getting a lot of interest. Why, because most people simply are not making money in today's market, and Joe knows it and the public knows it.



Economist Eliot Janeway believes that President Johnson's ability makes it a "new ball game", and he is bullish on the big picture, but Humphrey Neill puts forth a completely contrary view on Johnson (see "Sundry Comments" section). Don Worden's excellent tape studies are showing important "big money distribution", and in his latest report Don says: "In the long run... you'll find it cheaper to believe the numbers and not your adrenal glands." In other words, if you have a method that works — don't throw it out for emotional reasons, because it will probably be "right" just about the time you have given up on it. Garfield Drew finds the long-term odd-lot picture bullish, but the intermediate picture much less so.

I could go on and on, but this will give readers a sampling of a few of this week's wildly varied reports. My conclusion: confusion begets confusion. The analysts in their writing are merely reflecting the difficulties and divergences which now characterize the market itself. In my own experience, I have learned that when a market becomes this complex and frustrating, it is in the process of distribution. When a market is under distribution, be careful—you are probably on the way to selling your stocks for less than you paid for them.



THE MARKET: On February 7 the Industrial Average rose above its January 28 peak (see Chart 2) to close

at an all-time high of 791.59. Rails closed up on the day but failed to better their corresponding (January 28) peak of 183.50. Thus an unconfirmed Industrial high was recorded. Volume was 4.7 million shares on February 7 — far below volume at preceding peaks. For instance, volume was running between 6 and 7 million shares during late-October, 1963, at which time Industrials were pushing to all-time highs. Again during early January, 1964, volume expanded to 4 to 5 million shares as Industrials set fresh new highs. Normally, volume tends to expand with successive penetrations. For this reason, the February 7 new (unconfirmed) high was suspect.

If volume on the upside is a gauge of bullish momentum, so are the totals of daily new highs (see Letter 244). The February 7 all-time Industrial high brought in 39 new highs for the day (while the 5-day average of new highs registered 26). This compares to the 1964 peak of 73 new highs on January 14 (at which time the 5-day average of new highs was 63).

The Friday (February 7) Industrial high was followed on Monday by early morning strength, but by the day's end Industrials were off almost 3 points, 83 more issues declined than advanced, and daily new highs (despite the early strength) actually shrank to 38 (below Friday's 39). This was followed on Tuesday (February 11) by a rally which took Industrials to a new all-time high of 792.16, Rails to 183.11 (39¢ under their preceding high). Volume on Tuesday's new high receded to 4.04 million shares with 27 new highs on the day.

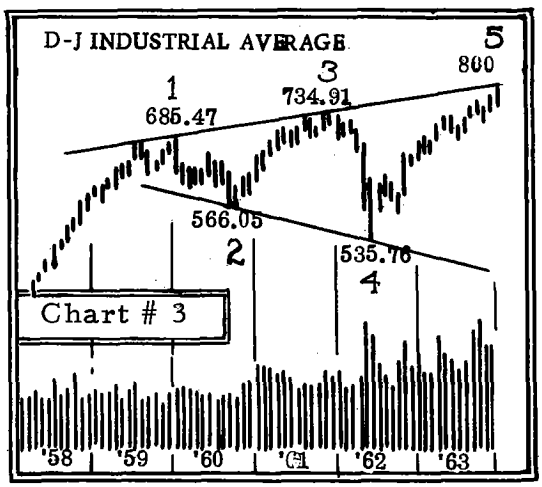
But the most significant aspect of the whole picture was brought to the attention of subscribers in the last Letter — the possibility of a second breadth-price divergence forming close on the heels of the breadth-price divergence of late 1963.

On January 9 (Chart # 1) Industrials closed at 776.65 while the advance-decline ratio recorded a 1964 recovery peak. A decline ensued, followed by a new high Industrial closing on January 24 of 783.04. A second decline occurred, followed by the historic high (791.59) of February 7. Thus Industrials have risen to three successive peaks (these peaks are marked 4, 5 and 6 on Chart # 1) accompanied by three declining peaks in the A-D ratio. (As this is written a fourth unconfirmed Industrial peak of 792.16 on February 11 has been recorded). If a forthcoming decline takes the A-D ratio below its February 5 level (Z on chart), the second major "sell signal" of the 1962-64 period will have been given.

What is the rationale for the rare technical phenomenon of a series of new Industrial highs in the face of a series of successive lows in the breadth index? First of all, we know that during a normal bull swing the majority of issues tend to move in the same direction as the leading "blue-chip" issues. In other words, during a bull swing everything tends to rise. When the A-D ratio (which gauges the direction of the majority of issues) parts company with the Industrial Average, then this constitutes abnormal action as far as history is concerned. A study of past markets shows that when abnormal action in the form of a breadth-price divergence occurs, the market is in a dangerous state, and the end result is a reversal of the trend which produced the abnormality.

Conclusion: market history shows that the longer a breadth-price divergence is ignored, the more severe the eventual reversal. There are bound to be many "healthy" bull movements in the years ahead — so why gamble on an "out-of-gear" movement in a turbulent market at this time?

THE BIG PICTURE The Industrial Average is now pressing against the "roof" of the huge "broadening triangle" about which I have written so much lately (see Letters 240 and 242 — new subscribers may write for copies). The 795-800 Industrial range represents the area of the upper trendline (point 5 on Chart #3), and a decisive bettering of the 800 level could produce a rare (and perhaps explosive) technical phenomenon, an upside "breakout" of a broadening pattern. Will the breakout actually materialize? The odds are against it (90% of all broadening patterns are resolved bearishly), volume so far is unfavorable (I would expect heavy, excited volume to accompany the actual breakout, rather than the 4 to 5 million shares daily that have characterized the recent market action). Finally, the decomposing breadth does not favor a resolution of the broadening pattern to the upside. Nevertheless, it is the market itself which will provide the final answer. We should know the answer before the first quarter of 1964 is over.



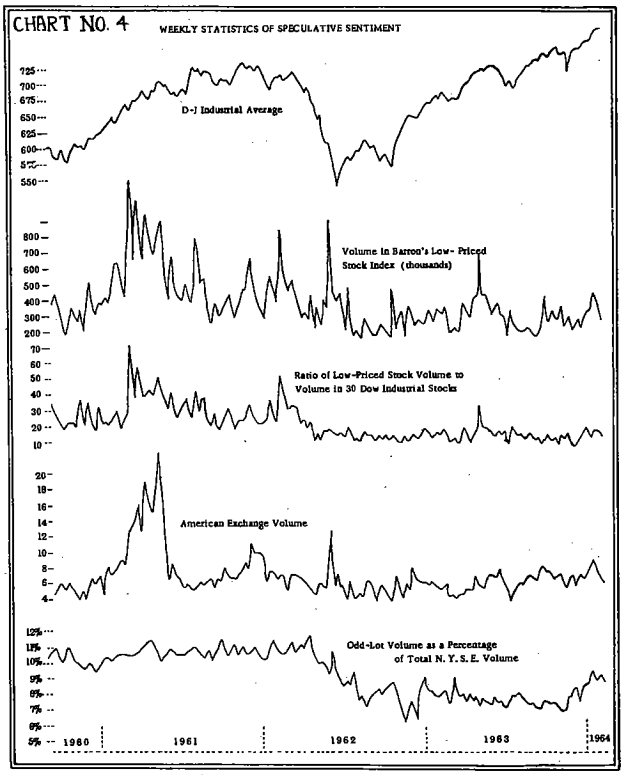
SPECULATION Chart # 4 (page 3) follows a group of indicators of speculative sentiment from the period of late-1960 to the present. This chart last appeared in Letter 227.

Note how dramatically these four indices rose during the 1960-61 market advance. Note also that all four indices "topped out" around May, 1961 — at which time the A-D ratio also turned down.

But what of the situation now, and what of the entire advance which began in October, 1962? The remarkable fact brought out by these four indices is that there has been little change in speculative sentiment since the 1962 lows. There was a minor spurt in Barron's low-priced stock volume during May-June, 1963, but that subsided when the A-D ratio turned down in May, 1963. And more lately, there has been a rise in odd-lot participation as a percentage of total N.Y.S.E. trading. All in all, however, I would say that the 1962-64 market has failed (so far) to stir up any marked speculative interest in those areas which

are normally most sensitive to crowd-excitement.

Among the many leading market analysts whose work I follow, a few contend that this market is fated to fizzle and fall with no further signs or hints of speculative interest. Others are convinced that a great surge of speculation lies directly before us — during the spring and summer of 1964.



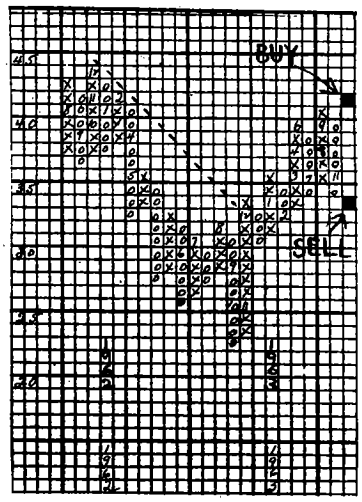
Personally, I confess to becoming more and more skeptical of the possibility of a resurgence in speculative activity over the period ahead. Breadth has been too poor, too much distribution has been going on, and the public cannot be expected to become excited over a market that produces more declines than advances for months on end. Note again that speculative interest rose with breadth in 1960-61, and that when the A-D ratio finally turned down, the excitement died too.

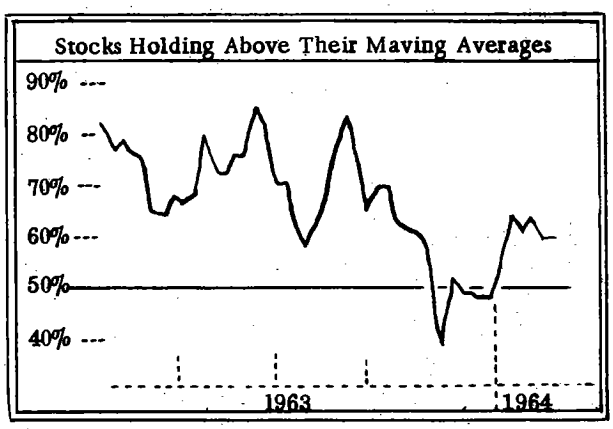
SUNDRY COMMENTS: A dream-like psychology (euphoria) rules the nation; one "feels" it everywhere. One sees it in the record auto sales, the booming consumer credit, the fantastic prices being paid for rare coins and works of art and pseudo-art. Most of the country's newspapers and magazines greeted the new year 1964 as "the year when the international scene points to peace and tranquility, and the domestic economy points to boom." Somehow, I cannot recall a time when true contrary opinion seemed more in order. Mr. Humphrey Neill of "Contrary Opinion" fame agrees, and in his latest report he states: "As for 1964, I rather suspect that this will be a year when politicians, as well as economists, may cringe a little as the news-events unfold." Already we are hearing about Red China and France, Malaysia and Indonesia, Uganda, Zanzibar, Panama, Guantanamo, Viet Nam, Cypress, a plane shot down in East Germany. I agree with Mr. Neill on the international picture — it could be a year to remember.

Mr. Neill voices a few more interesting contrary opinions: (1) President Johnson will "fail to be the miracle man he is reputed to be." (2) "The popularity Mr. Johnson presently enjoys among businessmen will fade." You may not agree or care for these opinions, but you will have to admit that they are pretty "contrary". Personally, I have learned not to "write off" Mr. Neill's contrary bets; I've seen too many of them come true.

STOCKS: Of 432 representative stocks which are tabulated at this office weekly, 255 or 59% are now holding above their 200-day moving average, no change from last week's (revised) 59%. This study remains bullish as long as the percentage figure holds above the 50% mark.

TRI-CONTINENTAL WTS. (TY)

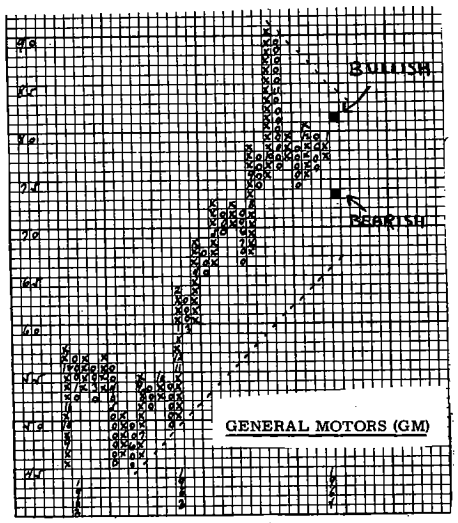


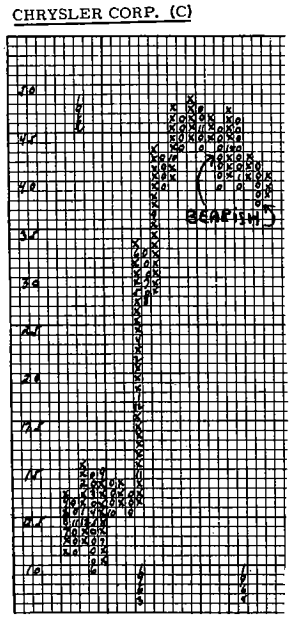


Point and figure charts are often extremely useful, particularly for clarifying situations and for providing "bullish" or "bearish" signals. P & F charts take only price movement into account. Time plays no part in P & F analysis nor does volume. I have included three very important P & F charts from the huge monthly volume put out by my friends at Chartcraft, Larchmont, New York. These are 3-point reversal charts, which means that each stock must go up or down a full three points before the movement is included on these diagrams. Each box on the charts represents one point; the X's indicate rallies and the O's indicate declines.

The widely followed Tri-Continental Warrants are shown here from the period of August, 1961, to the present. Here we see another advantage of P & F—condensation. All the 3-point reversals in the warrants which occurred during a period of over two years are contained in this one small diagram. The bellwether Warrants have reversed a bearish trendline as shown on chart and have now formed a box or series of narrow fluctuations. Sooner or later the Warrants must give a bullish or bearish

signal, and I have drawn in solid black boxes to represent potential "breakout" points. The "buy" signal would be a price of 42 on the Warrants, the "sell" signal a price of 33, although 32 would more completely reverse the structure to the downside.

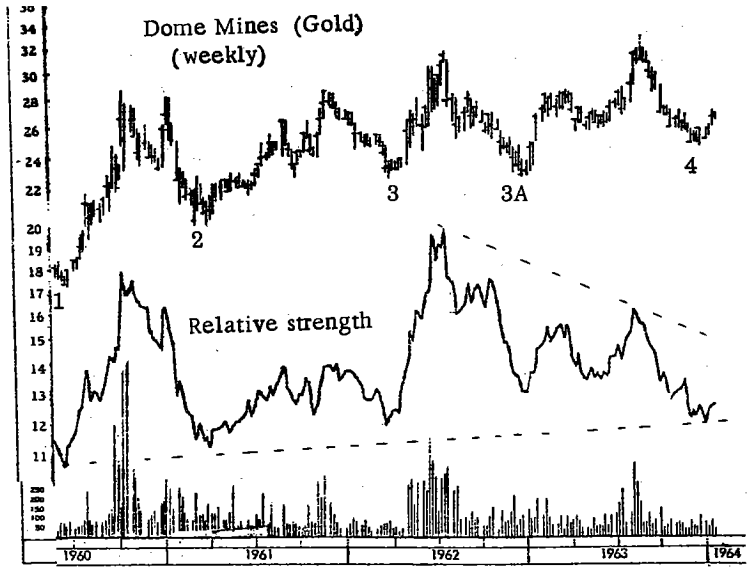




The P & F chart of General Motors, leader in the economy-moving Auto group is worth studying. GM has moved up from a long rising trendline but has also formed a declining trendline from its recent all-time high. The P & F chart of GM shows a picture of hesitation and indecision; a price of 82 would be bullish and a price of 74 would be bearish.

From the P & F standpoint, Chrysler gave a sell signal (following its mighty 1962-63 rise) when the "toppy" formation shown on chart broke to 43 (first arrow on chart). The top then increased in size, and a second sell signal was given when the price touched 38.

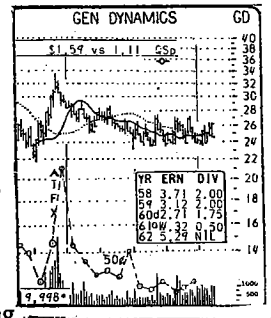
Incidentally, there has been much talk lately about what happens when GM tops out. I went over my historical charts and here's what occurred at important tops. GM turned down in March, 1929, six months before the famous Industrial high. GM turned down in November, 1936, four months before the 1937 bull market peak. GM turned down in February, 1946, three months before the 1946 bull market peak. GM topped in November, 1955, five months before the April, 1956, Industrial peak. GM turned down in July, 1959, six months before the January, 1960, Industrial peak. GM hit its high in December, 1961, right with the Dow. In the current situation, GM made a peak (see P & F chart) in late October, 1963. The rest is up to the market.

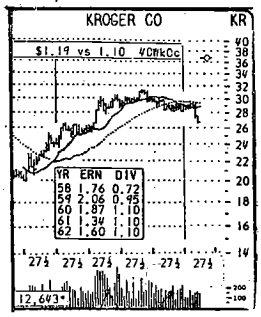


Many subscribers have requested a review of the golds. Dome Mines (a typical gold stock) shows five rising bottoms since 1960, and following each bottom the stock has approached or bettered its previous high. Point 3 and 3A on chart may be considered a double bottom, and following 3A , DM rose in 1963 to a 25 year high. This year Dome has again declined to lower levels (but well above point 3A), and note the decline in volume on the retreat. The 10-week moving average on DM is now 25 3/4, and I consider the stock attractive at these levels for long-term commitments.

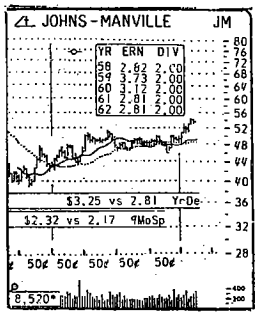
* * * *

I note that despite the appearance of strength in the market, very few stocks are actually "moving out". There are some good performers such as the Eastern Rails and the Airlines — but there are not many of these. Of the many hundreds of stocks which I have reviewed this week, three shown below are particularly interesting.





General Dynamics (whose layoffs have battered San Diego's economy for two years) may now have discounted the worst. The stock has been fluctuating within a narrow 4-point range for the last nine months. This week it pushed out (above 28) on the upside. If I had confidence in the market, I would not hesitate to buy GD here.... Johns Manville is a laggard component of the D-J Industrial Average. A two-year decline in relative strength shows signs of reversing in JM, and the stock may finally be ready to do something. JM has pushed above its 200-day moving average during the past two months.... Supermarket chains must be giving us chow-hounds too much for our money, because the stocks are all "topping out." The most recent victim is giant Kroger. The stock is a short sale as near to 29 as possible with a "stop-buy" at 30. As a matter of interest, I include a chart of the A & P. This shows what can happen to a top-quality "defensive" stock or any other stock during a market in which breadth is going down. I do not believe this would have occurred during a strong bull movement.



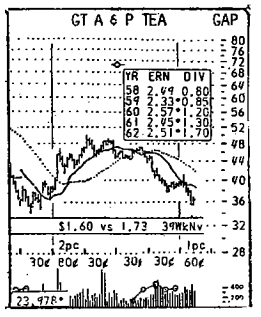


Chart # 1 and chart of Dome courtesy of Traders Research, 1431 Pearl Ave., Alton, Ill., 62003. All small charts on page 4 courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas.